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MAY 7, 2004

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## COMPANY SUMMARY

### Friday, May 7, 2004

**Speaker: Bob Cummins**

**Food Industry Comment:**

**Dean Foods** (DF-\$35), the leading dairy products processor and marketer, is coping successfully with sharply rising commodity prices, while continuing to achieve strong growth for its proprietary branded products. Management expects cost pressures to have an adverse impact on earnings in the June quarter, and has reduced its EPS guidance for the year, although even the low end of the revised range would represent 8% growth over last year's record high. The shares rose in response to the 1Q earnings report and conference call discussion, perhaps indicating that investors had anticipated worse news, and were favorably impressed by Dean's responses to the cost issues. We continue to regard Dean Foods as one of the most dynamic companies in the food industry, and despite the near-term uncertainties maintain our "1" (Strong Buy) rating, but are shading our 12-month target price range from \$42 - \$43 to \$41 - \$42 to reflect reduced earnings estimates.

First-quarter sales increased 14%, but that was attributable mainly to acquisitions and price increases to cover higher costs for raw milk, butterfat and other inputs, although growth in strategic brand volumes also contributed. Corporate operating income before plant closing expenses rose 3%, as strong earnings gains for the Branded Products Group and Dean's Spanish subsidiary, as well as lower corporate expenses, offset a small earnings decline for the Dairy Group, and a larger one for Specialty Foods. Lower interest expense and increased shares outstanding led to a 7% rise in diluted EPS to \$0.45 versus \$0.42. That was the midpoint of management's predicted range, but the earnings gain was only half the 14% average increase over the previous eight quarters.

The **Dairy Group** reported an 11% increase in 1Q sales as a result of three acquisitions over the past 12 months, as well as price increases to cover increased costs for milk and butterfat, which averaged 16% and 66% above 1Q-03, respectively, due to reduced production by dairy farmers and increased demand, especially for cheese. Under the circumstances, the group's 2% profit decline was a favorable showing, reflecting prompt pricing action by the company as well as plant consolidations and other steps to reduce costs. The operating margin in Dairy was 7.1%, down 90 basis points, but still well above industry levels. Margin pressures will intensify in 2Q, with milk costs averaging well above 1Q, but management is optimistic that milk prices will peak in June, and that some relief will be seen in the second half.

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The **Branded Products Group**, Dean's principal growth vehicle for the long term, reported strong increases of 68% in sales and 95% in operating income in 1Q. Much of the increase reflects the recent acquisition of Horizon Organic, but on a pro forma basis, adjusted to include Horizon and exclude a 2003 divestiture, segment volume increased 22% versus 1Q-03. The company's strategic brands (excluding certain non-core products) achieved growth of 28% in volume and 36% in dollar sales, with volume up 36% for Silk soymilk and 30% for Horizon organic milk. The first national advertising campaign for Silk began in April. Other strategic brands include International Delight, Hershey's (licensed), Land O' Lakes (licensed), Marie's, and Dean's. The Branded Products segment operating margin in 1Q was 6.2%, up 88 basis points from a year ago. Management expects to achieve double-digit margins by the second half, reflecting seasonal increases in volumes, the timing of marketing expenditures, the absence of incentive payments to the former owners of Silk, which ended in March, and ongoing steps to increase efficiency and eliminate excess costs.

The **Specialty Foods Group**, which has a high percentage of private label products, and cannot raise prices quickly, had a difficult 1Q due to inflation in such commodities as soybean oil (+47%), casein (+42%), and cheese (+80%), as well as higher costs for packaging and outbound freight. The segment reported increases of 1% in volume and 2% in net sales in 1Q, but operating income fell 17%, reflecting not only rising costs but also the Fleming bankruptcy and the California supermarket strike, which was settled at the end of February. The unit's 11.7% operating margin was the highest among Dean's three business segments, but that was well below the prior year's 14.2%. Management expects its earnings to remain under pressure over the near term. Specialty Foods, accounting for 7% of sales in 2003, is one of the nation's leading manufacturers of pickles, and also makes powdered non-dairy coffee creamers, aseptic sauces and puddings, and other products, for both retail and foodservice customers. We believe these businesses may eventually be divested.

In view of the severe cost pressures currently being experienced, Dean expects 2Q earnings from operations to be in the \$0.47 - \$0.50 range, 11% - 16% below last year's record \$0.56. Through a combination of price increases, cost controls, and an easing of supply/demand imbalances for milk and other commodities, management looks for a resumption of earnings growth in the second half, and tentatively projects EPS at \$0.54 - \$0.57 (versus \$0.52) for 3Q, and \$0.72-\$0.76 (versus \$0.56) for 4Q. Earnings guidance for the full year, excluding one-time items, is now \$2.21 - \$2.28 (up 8% -11%), down from a previous \$2.28 - \$2.34 (up 11%-14%). On the conference call, management declined to comment on earnings potential for 2005, but obviously to the extent that this year's results fall below trend-line, it would be reasonable to expect next year to show above-average growth, as profit margins recover to more normal levels. Our preliminary estimate is \$2.60.

We have a high degree of confidence in the Dean Foods management and its ability both to carry out its long-term growth plans successfully, and also to guide the company through difficult periods such as the present with minimum disruption to the bottom line.

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**Strong Buy ("1").** The stock's total return is expected to exceed significantly the average total return of the analyst's industry coverage universe over the next 12 months.

**Buy ("2").** The stock's total return is expected to exceed the average total return of the analyst's industry coverage universe over the next 12 months.

**Neutral ("3").** The stock's total return is expected to equal the average total return of the analyst's industry coverage universe over the next 12 months.

**Sell ("4").** The stock's total return is expected to be below the average total return of the analyst's industry coverage universe over the next 12 months.

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